

**May 2, 2017**

**Honorable Member, U.S. House of Representatives Committee on Financial Services**

**Re: The flawed provisions on Federal Reserve governance and conduct in the Financial Choice Act**

The Financial CHOICE Act (FCA) would make a number of sweeping changes to the institutions that oversee the American monetary and financial system. The sum of these changes would be deeply damaging to the cause of maintaining financial and economic stability in the U.S. economy. Of particular concern are the changes the FCA would make to the conduct and governance of the Federal Reserve. One of the most important of these is the “directive policy rule” (DPR). Contrary to claims made by the bill’s proponents, a DPR would have provided no useful guidance to Fed policy over the past decade, when the Fed’s actions consistently provided needed support for the U.S. economy as it struggled to escape and recover from the Great Recession.

Another ill-considered change in the FCA is its dilution of voting power of Federal Reserve Governors and the consequent elevation of voting power of regional Federal Reserve Bank presidents. Federal Reserve governors are nominated by the President and confirmed by the Senate, providing at least some measure of democratic accountability. Presidents of regional Federal Reserve banks are, by contrast, chosen by deeply unrepresentative boards of directors in opaque processes. Until the process of selecting regional Presidents is reformed in a way that ends the capture of these boards by financial and corporate interests, it will not improve Federal Reserve governance to shift power in this way.

## **I. The “Directive Policy Rule”**

The “Directive Policy Rule” is the requirement that the Federal Reserve specify and follow a fixed and rigid mathematical rule (“Directive Policy Rule” (DPR)) that would instruct it how to set monetary policy so as to achieve its mandate of stable prices and maximum employment based on macroeconomic variables.

Calls for a DPR largely stem from arguments that the Fed’s actions during and following the Great Recession of 2008-2009 have been too *ad hoc* and failed to contribute to a faster recovery or led to a dangerous buildup of inflationary pressures. The argument continues that monetary policymaking would be improved by following a strict formula. All of these views are incorrect, we take them in turn below.

### **The Fed's actions over the past decade were not *ad hoc* and they did work**

The Fed's extraordinary actions in the last decade did not come out of the blue and were not taken on a whim - they were instead taken in response to extraordinary economic circumstances. The crash of the \$7 trillion housing bubble that began in 2007 eventually led to a larger negative shock to private-sector spending than the one that led to the Great Depression in the early 1930s. The Fed actually began attempting to cushion the coming blow by lowering short-term interest rates as early as August 2007, and began providing support to failing financial institutions early in 2008.<sup>1</sup>

This support to financial institutions led the Fed to expand its balance sheet to provide direct lending via emergency facilities in an effort to restore financial market functioning after the banking crisis in fall 2008. This direct lending roughly doubled the size of the Fed's overall balance sheet, raising it from just below \$1 trillion to roughly \$2 trillion. By the spring of 2009, this direct lending through the emergency facilities had substantially declined as chaos in financial markets had largely subsided, as exemplified by historically large spreads between Treasury interest rates and other assets' returns. At this point, without further action, the size of the Fed's balance sheet (and hence the liquidity being provided to the U.S. economy) would have shrunk quickly back down to pre-recession levels.

Largely driven by the desire to keep providing monetary support to a still-contracting economy, the first round of large-scale assets purchases (LSAPs, sometimes popularly known as quantitative easing, or *QE*) began when the Fed announced in March 2009 that it would commit to purchasing \$300 billion in Treasury securities, \$200 billion in agency debt, and \$1.25 trillion in mortgage-backed securities. The purchases were completed by the spring of 2010. This raised the question of what to do about maturing assets; if the Fed did not replace them as they matured, the balance sheet would decline by \$100 to \$200 billion annually as assets naturally reached maturity (a process sometimes known in the jargon as *rolloff*). To forestall this automatic shrinking of their balance sheet, the Fed announced in August 2010 that it would purchase Treasury securities to replace the maturing securities to keep the size of its balance sheet stable.

The second round of LSAPs (QE2) began in November 2010 with an announcement that the Fed would purchase an additional \$600 billion in Treasury securities (at a pace of roughly \$75 billion per month) by June 2011. It further committed to continuing to replace maturing securities with Treasury purchases.

While the official end of the Great Recession had occurred in June 2009, more than a year before, the U.S. unemployment rate in November 2010 was *higher* than at the recession's trough (9.8 versus 9.5 percent). Employment had fallen by nearly 300,000 since the recession's trough and contracted in four of the five months before November

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<sup>1</sup> Most of this policy and economic background is contained in Bivens (2015), found at: [https://www.brookings.edu/wp-content/uploads/2016/06/Josh\\_Bivens\\_Inequality\\_FINAL.pdf](https://www.brookings.edu/wp-content/uploads/2016/06/Josh_Bivens_Inequality_FINAL.pdf)

2010. In retrospect, a consistent round of job growth (which of course could have been in part endogenous to the introduction of QE2) actually began in October 2010, but in real-time the recovery seemed to be stubbornly stalled.

The final round of LSAPs (QE3) began with an announcement in September 2012 that the Fed would purchase \$40 billion in market-backed securities (MBS) per month. This announcement had no end date and no ceiling on the total amount that would be purchased. In December of 2012, the Fed then announced that it would also begin purchasing \$45 billion in Treasury securities (in addition to the MBS purchases). In December 2013, the Fed announced that it would begin reducing the size of monthly purchases, and in February the pace of total purchases declined from \$85 billion to \$65 billion. The purchases ended in October 2014, with the Fed's balance sheet at roughly \$4.5 trillion.

When QE3 was announced, the unemployment rate stood at 7.8 percent after having declined a full percentage point in the previous year. Yet there were reasons to think this progress could slow. For one, about a third of the change in unemployment between November 2010 (the beginning of QE2) and September 2012 (QE3) was due to falling labor force participation rather than employment growth. Further, the "fiscal cliff" was clearly on the horizon. In January 2013 a number of fiscal stimulus measures were set to expire, and the long-scheduled expiration of tax cuts passed in 2001 and 2003 was set to occur. If all the different elements of the fiscal cliff had come to pass, there would have been a very large increase in fiscal drag in 2013, and the first half of that year would likely have seen negative output growth. It seems hard to believe that this worry was not a significant part of the Fed's decision making regarding QE3.

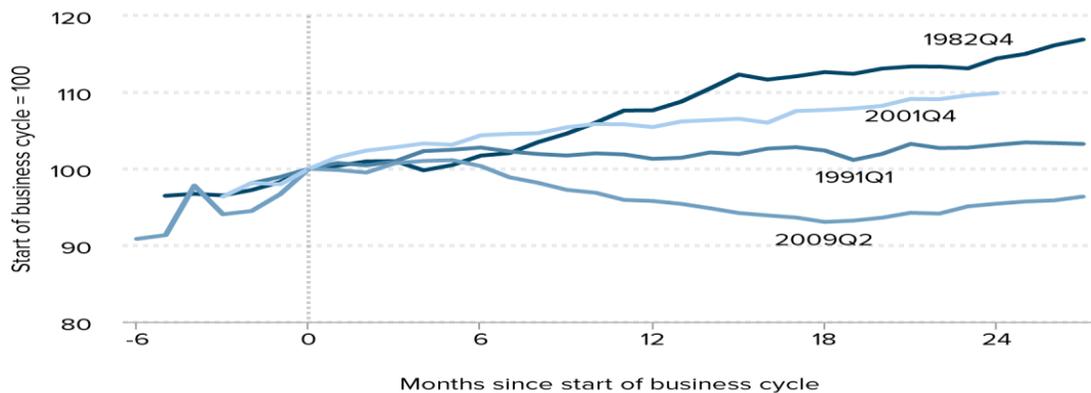
Finally, by September 2012, it was clear that the spending reductions forced into law by the Budget Control Act (BCA) were going to place severe downward pressure on demand growth in coming years. In fact, since the trough of the Great Recession in 2009, combined government spending has been slower in the ensuing recovery than in any other previous post-war recovery. This *fiscal* austerity occurred even as the cumulative output gap (essentially a measure of the damage caused by the recession) was larger at the end of the Great Recession than at any other recession, and when conventional *monetary* policy was largely de-fanged. The Fed's search for additional tools to boost economic growth in this context seems in retrospect very wise indeed.

Recognizing the historically unprecedented extent of fiscal austerity in recent years also provides the clearest critique of the claim that the Fed's extraordinary policies failed to spur a faster recovery from the Great Recession. This fiscal austerity can fully explain the slowness of recovery, even with monetary policy tailwinds.

Figure 1 (from Bivens (2016))<sup>2</sup>

## Fiscal austerity explains why recovery has been so long in coming

Change in per capita government spending over last four business cycles



**Note:** For total government spending, government consumption and investment expenditures deflated with the NIPA price deflator. Government transfer payments deflated with the price deflator for personal consumption expenditures. This figure includes state and local government spending.

**Source:** EPI analysis of data from Tables 1.1.4, 3.1, and 3.9.4 from the National Income and Product Accounts (NIPA) of the Bureau of Economic Analysis (BEA)

Economic Policy Institute

## The Fed's actions over the past decade are have not primed dangerous future inflation

Contrary to much speculation, extraordinary Fed actions did not cause accelerating inflation, nor have they inevitably laid the groundwork for it.<sup>3</sup> This was not a surprise to those arguing that the Fed and fiscal policymakers should be attempting to boost aggregate demand growth. So long as aggregate demand growth runs slower than growth in the economy's potential capacity, prospects for a sustained, significant rise in inflation are essentially nil.

The argument for viewing Fed actions as inflationary is rooted in a far too-simple view of the inflation process, often summarized in the words of Milton Friedman: "inflation is always and everywhere a monetary phenomenon". From this perspective, the rise in "base money" spurred by Fed actions during the Great Recession was viewed as the obvious monetary phenomenon that would spark inflation. Yet, as Willem Buitier has pointed out, inflation is essentially the price of money. Saying that inflation is always and everywhere a monetary phenomenon is essentially as deep or illuminating as saying that "the price of bananas is always and everywhere a banana phenomenon".<sup>4</sup>

<sup>2</sup> For Bivens (2016), see: <http://www.epi.org/publication/why-is-recovery-taking-so-long-and-who-is-to-blame/>

<sup>3</sup> See <http://www.nytimes.com/2009/05/04/opinion/04meltzer.html> or <https://www.wsj.com/articles/SB10001424052702303939404579527750249153032> for examples of predicting inflation

<sup>4</sup> For the full context of his comments, see Buitier (2006): <http://willembuitier.com/globinf.pdf>

What's missing in simple monetarist views of potential inflation during the past ten years was recognition of the ferocious downward pressure on prices stemming from the prolonged gap between aggregate demand and productive capacity. This output gap trumped anything else in keeping inflation (of both wages and prices) tame.

Occasionally the claim is made that only the Fed's decision to begin paying interest on excess reserves kept hypothesized inflation from emerging. The argument seems to be that these interest payments kept money bottled-up that otherwise would have flowed rapidly out of Fed reserves and into demand for goods and services. This is clearly implausible. The Fed's interest payments on excess reserves were less than 50 basis points as recently as November 2016. It seems completely implausible that interest payments this low was all that stood in the way of significantly higher inflation.

### **A "Directive Policy Rule" would not lead to better policy**

The most famous DPR is the "Taylor Rule", named for Stanford economist John Taylor. The "Taylor Rule" is clearly the hoped-for model for the DPR - the CHOICE Act explicitly calls for the Taylor Rule to be calculated if it is not chosen as the DPR, and if the DPR deviates from the Taylor Rule, the Federal Reserve Chair must come to Capitol Hill to explain to Congress why.

The Taylor Rule is premised on the view that the short-term interest rates that are the primary tool of modern monetary policy should be set with a rigid, fixed mathematical rule that hinges on 2 variables and 2 "weights". The variables are the output gap (a measure of how much aggregate demand lags the economy's productive capacity) and inflation. The "weights" are how much importance the Fed should attach to these variables in formulating policy. In a perfectly-certain world with an unchanging relationship between inflation and aggregate demand, a Taylor Rule would work fine as a firm guide to policy. But perfect certainty and unchanging relationships between measures of aggregate demand and inflation do not exist. This means that prescriptions stemming from mechanically following a Taylor Rule would often lead to damaging policy errors.

We should note that John Taylor himself noted this, in his early formulations of the rule. He explicitly noted that his role was descriptive, not prescriptive (that is, it empirically explained *what the Fed actually did*, not *what it should have done*). In his 1993 paper that introduced the Taylor Rule, Taylor (1993) noted<sup>5</sup>:

*"Even with many such modifications, it is difficult to see how...algebraic policy rules could be sufficiently encompassing. For example, interpreting whether a rise in the price level is temporary or permanent is likely to require looking at several measures of prices (such as the consumer price index, the producer price index, or the employment cost index). Looking at expectations of inflation as measured by futures markets, the term*

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<sup>5</sup> For a copy of this paper, see: <http://web.stanford.edu/~johntayl/Papers/Discretion.PDF>

*structure of interest rates, surveys, or forecasts from other analysts is also likely to be helpful. Interpreting the level and the growth rate of the economy's potential output—which frequently is a factor in policy rules—involves predictions about productivity, labor-force participation, and changes in the natural rate of unemployment. While the analysis of these issues can be aided by quantitative methods, it is difficult to formulate them into a precise algebraic formula. Moreover, there will be episodes where monetary policy will need to be adjusted to deal with special factors. For example, the Federal Reserve provided additional reserves to the banking system after the stock-market break of October 19, 1987 and helped to prevent a contraction of liquidity and to restore confidence. The Fed would need more than a simple policy rule as a guide in such cases.”*

Taylor's original thoughts were right: monetary policy should be evidence-based and systematic, but it cannot be run on autopilot, for many reasons. For one, policymakers have a hard time measuring the output gap. The years between 2013 and 2015 saw literally dozens of papers written by academic researchers disagreeing on the central question of how much “slack” remained in the American labor market (and hence implicitly disagreeing on how large the current output gap was). Adopting a Taylor Rule does not make monetary policy magically “easy” or “predictable” when the ingredients for the rule themselves are subject to debate.

Besides this problem, there is also no economic guide to what the “weights” on the output gap and inflation should be. In theory, these weights should reflect policymakers' assessment of the economic damage done by excess unemployment versus excess inflation, but these assessments vary widely.

Perhaps most importantly, the Taylor Rule also provides no guidance for times when the correct interest rate that holds the output gap and inflation at the desired levels (the “neutral long-run interest rate”) itself changes over time. There is ample economic research that this is exactly what has happened in the U.S. economy in recent years.<sup>6</sup>

Criticisms of the Fed's conduct in the past decade that compare it to what would have been prescribed by a simple Taylor Rule often use *contemporary*, not *real-time* data to make these criticisms. This is not just unfair, it is bad economics. Federal Reserve policy is made with real-time data. If subsequent data revisions show that (for example) inflation was actually faster than the real-time data was indicating, or that the output gap was smaller, than the Fed's decisions could certainly turn out to have been in the wrong direction in retrospect. But there is constant uncertainty in policymaking, and the uncertainty goes both ways; subsequent data revisions are equally likely to show that

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<sup>6</sup>For evidence on the decline in the neutral rate, see: <http://www.frbsf.org/economic-research/files/wp2015-16.pdf>

the Fed was too fast to tighten policy as it is to show they were too slow. Simply put, because policy is made with real-time data, it should be assessed the same way.<sup>7</sup>

Finally, and related, the Taylor Rule provides no guidance on what to do when the prescription it provides is for negative interest rates - as it did for multiple years in the last decade. Should the Fed try to set short-term rates negative in these cases, perhaps by utilizing negative rates paid on excess reserves held at the Fed? Or should they look to lower longer-term interest rates, like they did with the LSAPs discussed before? The Taylor Rule provides no help with these key questions.

The provisions in the CHOICE Act to set a DPR that takes all future uncertainty out of monetary policymaking are ill-considered and potentially dangerous. They should be rejected.

**The Regional Fed Presidents should not have more power on the FOMC, particularly not before the process of choosing them has been improved**

The Governors of the Federal Reserve Board in Washington, DC are nominated by the President and confirmed by the U.S. Senate. They therefore have at least some prospects for democratic accountability. The presidents of regional Federal Reserve banks are chosen by the boards of these banks in often opaque processes. These regional bank boards are overwhelmingly made up of financial and corporate sector interests. Unsurprisingly, besides being slanted towards these economic interests these board also have a dismal record in promoting diversity in gender, race and ethnicity, both for themselves as well as for the Presidents they choose.<sup>8</sup>

The fact that regional Federal Reserve bank presidents are chosen by board that are overwhelmingly made up of financial and corporate interests is by far the biggest current threat to genuine “independence” of the Fed. Federal Reserve “independence” is a concept that nearly all policymakers on Capitol Hill invoke ritualistically whenever the Fed is urged to give the economic interests of low and moderate-wage workers the due they deserve in policy debates. But defending the *status quo* of Fed decision-making is not a defense of genuine independence, instead it’s a defense of independence from pressure *besides that imposed by financial and corporate interests that run regional boards*.

These regional boards currently by law account for 5 of the 12 voting slots on the Federal Open Market Committee (FOMC), where monetary policy decisions are made.

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<sup>7</sup> If the criticism of Fed policymaking over the past decade was that there was always a predictable *bias* in the real-time data that they should have recognized, that seems like fair game. But I’ve never heard such a criticism, and it would really have nothing to do with any rule, Taylor or otherwise, it would simply call for improved real-time data collection.

<sup>8</sup> It is also worth noting that the process of picking regional bank presidents is the one that selected Jeffrey Lacker for the Richmond Fed, and Lacker’s recent confession to having leaked Federal Reserve data to private-sector financial firms just highlights the too-chummy relationship between regional bank boards, presidents, and private-sector finance.

Given that 2 Federal Reserve board governor positions are vacant, there is currently a 50-50 split in voting power at the FOMC between democratically-accountable governors and regional bank presidents. But even 5 of 12 is too many slots for regional bank presidents, at least until the boards and the process that selects them is reformed.<sup>9</sup>

For any questions regarding this letter, please contact Josh Bivens at [jbivens@epi.org](mailto:jbivens@epi.org).

Sincerely,

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<sup>9</sup> For thoughts on reform and statistics on current makeup of these boards, see: <https://populardemocracy.org/sites/default/files/Fed%20Up.pdf>